

Internal Revenue Service
memorandum

CC:TL-N-10071-91

Br1:HFRogers

date: SEP 20 1991

to: District Counsel Milwaukee CC:MIL
Attn: Steven R. Guest

from: Assistant Chief Counsel (Tax Litigation) CC:TL

subject: [REDACTED]

This is in response to your request dated August 30, 1991, for tax litigation advice.

ISSUES

1. Whether petitioners are taxable on the income received pursuant to the land contract.

2. Alternatively, whether petitioners have a gain in the year that the land contract was assigned to a trust.

3. Whether petitioners are taxable on the capital gains resulting from the principal payments received pursuant to the land contract.

CONCLUSIONS

1. The petitioners are taxable on the income received pursuant to the land contract.

2. The petitioners did not have a gain in the year in which they assigned the land contract to a trust.

3. Petitioners are taxable on the capital gains resulting from the principal payments received pursuant to the land contract.

FACTS

On [REDACTED], petitioner, [REDACTED], purchased real property from an unrelated third party for \$[REDACTED]. As part of the purchase, [REDACTED] assumed a note to a bank which had an outstanding balance of \$[REDACTED] at the time of the purchase.

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On [REDACTED], [REDACTED] sold the land to two individuals for \$[REDACTED]. Of this amount, [REDACTED] financed \$[REDACTED] via a land contract for [REDACTED] years at [REDACTED] percent interest.

On their [REDACTED] and [REDACTED] income tax returns, petitioners reported the sale as an installment sale. They properly reported interest income and capital gains resulting from the receipt of principal payments pursuant to the land contract. Petitioners also deducted interest payments [REDACTED] made on the assumed note.

On [REDACTED], [REDACTED] set up an irrevocable trust for the benefit of his [REDACTED] children which was to terminate upon the later of [REDACTED], or the death of petitioner's last child. The [REDACTED] was the trustee. [REDACTED] assigned the land contract to the trust. The assignment expired [REDACTED]. The net income from the trust property was to be divided into [REDACTED] equal shares and held in separate income accounts. The principal payments from the land contract were allocated to the trust principal. The trust assumed the obligation to pay the assumed note. [REDACTED] was obligated to pay all capital gains taxes.

During [REDACTED] and [REDACTED], petitioner borrowed money from the trust without adequate security. Also, the trustees made several disbursements on behalf of the trust beneficiaries to pay their post-high school educational expenses.

The trust beneficiaries did not report the interest income. The petitioners did not report interest income or capital gains.

On [REDACTED], [REDACTED] transferred legal title to the property to one of the purchasers. On [REDACTED], the trustee quitclaimed any interest it might have in the property to the purchaser. On [REDACTED], the bank executed a satisfaction of mortgage with respect to the assumed note.

DISCUSSION

Interest income

Pursuant to I.R.C. § 61, gross income includes all income from whatever source derived including gains derived from dealings in property and interest income. Section 61(a)(3), (4). As the Tax Court has recognized:

[O]ne who is entitled to receive income at a future date cannot avoid tax liability on such income by making a gift of it by

anticipatory assignment. The power to dispose of income - even if such power is exercised by causing the income to be paid to another - is the equivalent of ownership for tax purposes. The owner of the income-producing property realizes the economic gain from the income by directing its disposition in a manner which serves his own needs or accords with his wishes. That result is the same whether the assignment of income is an irrevocable assignment, and regardless of whether the income is assigned for a substantial period of time. (Citations omitted).

Hudlow v. Commissioner, T.C. Memo. 1971-218, 30 T.C.M. (CCH) 894, 914.

In Hudlow, the Tax Court determined that the taxpayers' assignment of their interest in a lease to a trust was tantamount to a mere assignment of income. The Service no longer maintains the position that an assignment of income occurs in situations such as Hudlow where the taxpayer receives the principal portion of each installment payment as the payment is made. Rather the correct analysis is that the grantor has a reasonable expectation of recovering a portion of the trust corpus within ten years from the inception of the trust and, therefore, the grantor has a reversionary interest in the corpus pursuant to section 673¹. Therefore, under section 671², the grantor is taxable on the interest portion of each installment paid to the

¹ Section 673 treats the grantor as the owner of any portion of the trust in which the grantor has a reversionary interest in either trust corpus or trust income if, as of the inception of that portion of the trust, the interest may reasonably be expected to take effect in possession or enjoyment within 10 years from the date of the transfer of that portion of the trust.

² Section 671 provides that when the grantor is treated as the owner of any portion of a trust, there shall be included in computing such owner's taxable income and credits those items of income, deductions and credits against the tax of the trust that are attributable to that portion of the trust to the extent that such items would be taken into account in computing taxable income or credits against the tax of an individual.

trust. Furthermore, under section 677(a)(1)³, the grantor is considered the owner of that portion of the trust corpus representing the principal portion of the installment obligation.

However, the above analysis does not apply in cases where a taxpayer transfers an installment obligation to a reversionary trust created for a period in excess of 10 years and, under the terms of the trust, the portion of each installment payment representing deferred profit and return of capital is allocated to the trust corpus and retained by the trustee. Under section 677(a)(2)⁴, the grantor would be regarded as the owner of the portion of the trust corpus representing the principal amount of the obligation because the principal amount of each installment payment is accumulated in trust corpus for future distribution to the grantor.

Because of the accumulation of income for future distribution to the grantor, the grantor is taxable on items of trust income allocable to the corpus when such income is received by the trust. See discussion, infra. However, the grantor is not taxable on the interest received by the trust on the installment obligation by virtue of the accumulation at issue. Rather such interest income would normally be taxable to the trust or its beneficiaries because the grantor is not treated under section 677 as the owner of the interest income. See Treas. Reg. § 1.671-3(b)(2); Rev. Rul. 79-223, 1979-2 C.B. 254.

Nonetheless, under the facts in the instant case, the grantor (petitioner) is taxable on the interest income received by the trust. The grantor borrowed money from the trust without giving adequate security therefor. These loans were not repaid before the beginning of the taxable year. Therefore, the grantor is treated as the owner of the corpus and is taxable on the interest pursuant to section 675(3)⁵ for [REDACTED], [REDACTED] and those

³ Section 677(a)(1) provides that the grantor shall be treated as the owner of any portion of a trust whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a nonadverse party or both, may be distributed to the grantor.

⁴ Section 677(a)(2) provides that the grantor shall be treated as the owner of any portion of a trust whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a nonadverse party, or both, may be held or accumulated for future distribution to the grantor.

⁵ Section 675(3) provides that the grantor shall be treated as the owner of any portion of a trust in respect of which the grantor has directly or indirectly borrowed the corpus or income and has not completely repaid the loan, including any interest,

subsequent years where the loan remained unpaid. However, the statutory notice is only through taxable year [REDACTED] so this theory is of limited utility. Nonetheless, although trust provision 4.2.3 states that the donor cannot borrow the principal or interest of the trust without adequate security, the actual course of dealing between the donor and the trust establishes that, in fact, the donor did borrow funds from the trust without adequate security. The Service can look through form to the substance of a transaction. Commissioner v. P.G. Lake, Inc., 356 U.S. 260 (1958). Therefore, under section 675(2)⁶, the petitioner has the power to borrow without adequate interest or security. Thus, he is considered to be the owner of the corpus and interest. Pursuant to section 671, because he is the owner of the corpus, he is taxable on all income resulting therefrom.

In addition, the petitioner is taxable on the income resulting from the trust corpus under the theory that trust income was used to pay legal obligations of the petitioner. Some of the trust income was used to pay post-high school educational expenses of the beneficiaries which could be considered a legal obligation of the petitioner under state law. These amounts would be considered income to the petitioner. Even more importantly, trust income (both principal and interest payments received) were used to pay the assumed mortgage. The petitioner remained liable on this obligation because the bank did not agree to the assumption of the obligation by the trust. Therefore, all amounts paid in discharge of the legal obligation of the grantor must be included in his gross income pursuant to Treas. Reg. § 1.677(a)-1(d).

Gain when assigned

The August 30, 1991, request for tax litigation advice queries whether an alternative argument should be made. Namely, if the assignment of the land contract to the trust resulted in a disposition of the contract so that petitioners must recognize as capital gain the amount representing the difference between the contract's fair market value and its basis to the taxpayer.

The petitioners elected to treat the sale of the property as an installment sale. Ordinarily, pursuant to section 453, taxpayers must recognize as income each year only the proportion

before the beginning of the taxable year.

⁶ Section 675(2) provides that the grantor shall be treated as the owner of any portion of a trust in respect of which a power exercisable by the grantor or a nonadverse party, or both, enables the grantor to borrow the corpus or income, directly or indirectly, without adequate interest or without adequate security.

of the payments received in that year which the gross profit bears to the total contract price. However, if the property is disposed of, the taxpayer must recognize gain or loss to the extent of the difference between the basis of the obligation and the fair market value of the obligation at the time of disposition. Section 453(d)(1).

Our theory under the prior issue (interest income) was that [REDACTED] was to be treated as the owner of the trust because he borrowed funds without adequate security and funds were used to pay his personal obligations. As was previously stated, the petitioner is considered to be the owner of the trust corpus pursuant to section 677(a)(2) because the principal amount of each installment payment is accumulated in trust corpus for future distribution to him. Because the petitioner is considered the owner of the trust corpus, the transfer of the obligation to the trust is not a section 453(d) disposition and petitioner must continue to report the deferred portion under section 453 as the installment payments are received by the trust. However, the petitioner does not have to report any capital gains from the transfer of the installment obligation to the trust because he is still considered the owner of the installment obligation.

Capital gains - principal payments

According to the August 30, 1991, request for tax litigation advice at p. [REDACTED], petitioners have conceded this issue. Therefore, only a brief analysis is included herein.

[REDACTED] retained a right to the deferred profit in the remaining installment payments because, at the termination of the trust, both the land contract and the principal payments made thereon would revert to [REDACTED]. Therefore, [REDACTED] remains the owner of that portion of the trust under the provisions of section 677(a)(2). See also Treas. Reg. § 1.677(a)-1(a),(b),(f),(g)(2); Treas. Reg. § 1.671-3(b)(2). Thus, petitioners must report the deferred profit on the principal portion of the monthly payments.

Please contact Helen Rogers, FTS 566-3442, if you have any questions or comments.

MARLENE GROSS

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Attachment:

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Administrative file